APA Q4 2022: Quarterly Commentary

MUNICIPAL MARKET OUTLOOK AND STRATEGY

Fourth quarter highlights

October was the third consecutive month of higher yields, as the 2, 5, 10, and 30-yr AAA muni spots rose by 9, 12, 9, and 22 bps, respectively.

At the Fed meeting in the first week of November, the FOMC implemented its fourth straight 75 bps hike of the year as the central bank continues to embark on one of the most aggressive rate-hiking cycles in history.

After seeing municipals sell off for the third consecutive month in October, the market quickly turned around over the year's final two months. Stated AAA yields beyond one year moved lower by 49 to 79 bps over November and December, with the most significant move coming from the 5-12 year maturity range.

The upward price movement was driven by a turnaround in Treasuries, while municipals outperformed on muted new issue supply and support from coupon and maturity reinvestment.

2022 ended with new issue supply of $384 billion. This was a year-over-year decline of nearly $100 billion vs. calendar year 2021 and the lowest annual figure since 2018.

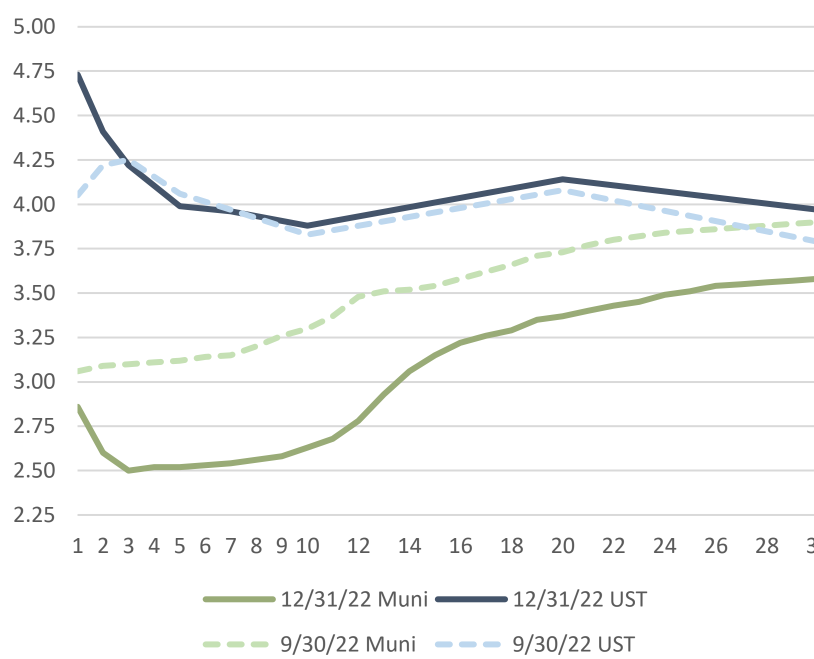
For the year, municipal mutual funds experienced net outflows of $160 billion the highest figure on record.

Market update

Municipals started the quarter moving lower in yield before ultimately succumbing to pressures from rising Treasury yields and sustained mutual fund outflows. Yields adjusted higher following the CPI report released in mid-October as the market priced in more aggressive Fed action to rein in inflation in response to the upside surprise. October was the third consecutive month of higher yields, as the 2, 5, 10, and 30-yr AAA muni spots rose by 9, 12, 9, and 22 bps, respectively. The 10-year AAA-muni tenor closed the month at 3.41% or 83% of Treasuries. This would ultimately be the highest stated AAA yield level reached for the year. Issuance for the month came in at just $25 billion, down 40% year over year and well below the previous five-year monthly average of $49 billion. Secondary market activity was elevated, as the average daily volume was $15.8 billion, the second-highest monthly level of the year. In a sign of a continued strong credit backdrop, Fitch upgraded the city of Chicago one notch to BBB from BBB- in late October and affirmed a positive outlook.

FIGURE 1

Muni & Treasury Yield Curves

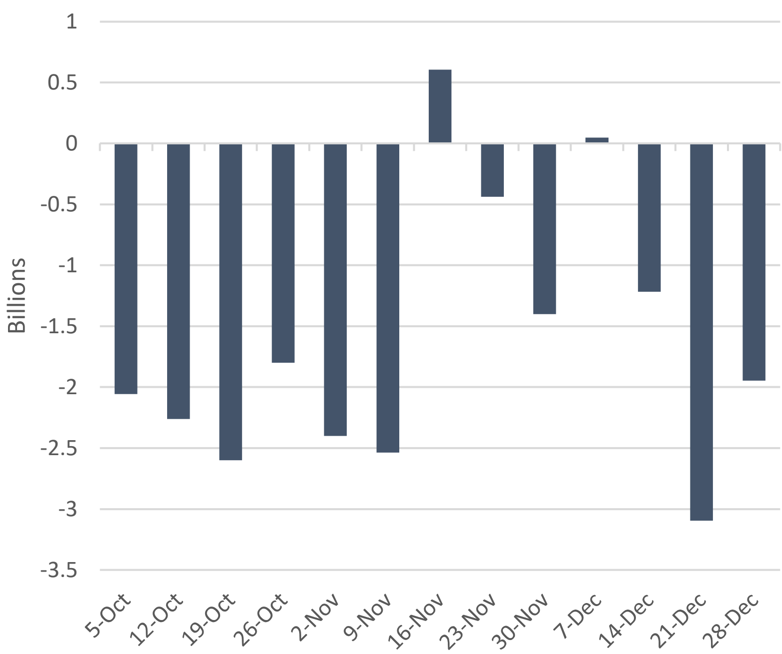


Source: Municipal Market Data, US Treasury

At the Fed meeting in the first week of November, the FOMC implemented its fourth straight 75 bps hike of the year as the central bank continues to embark on one of the most aggressive rate-hiking cycles in history. However, bond

FIGURE 2

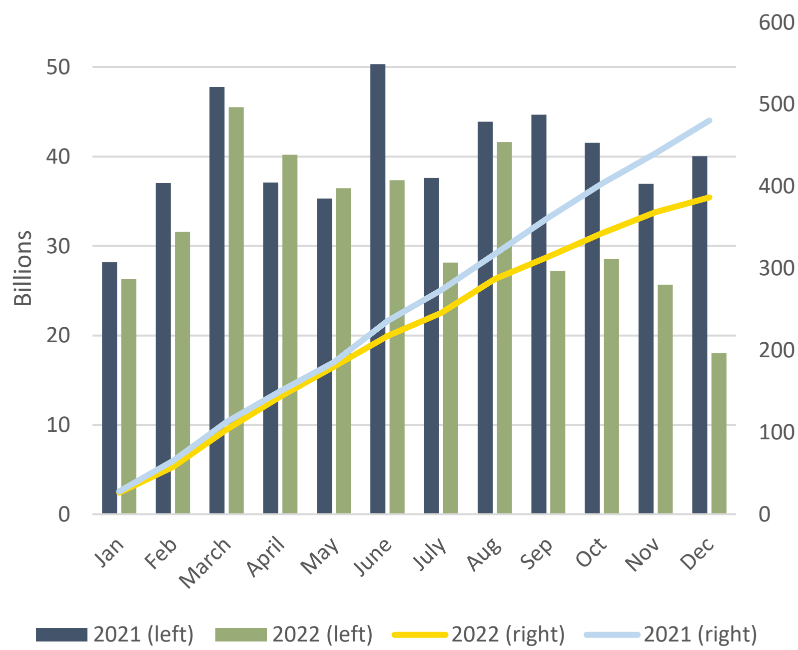
Weekly Fund Flows



Source: Lipper Data

FIGURE 3

Municipal Market Supply



Source: SIFMA

Market update (continued)

prices rallied, and yields moved lower for the month, on the expectations that the Fed might begin to moderate the pace of tightening, as Chair Powell indicated that it could be appropriate to slow the pace of rate increases "as soon as the next meeting or the one after that," while also stressing that "we still have some ways" to go before rates were sufficiently restrictive. Municipals benefitted from Treasury yields moving lower, suppressed new issue supply, a turnaround in demand (alleviating selling pressures), and a shift in Fed sentiment. November ended as one of the best months for performance for the asset class in 30 years. Supply for the month came in at just $22 billion, the lowest for November in over 20 years. Longer-end Treasury yields outperformed, as the month ended with the 2-10 year UST spread at -70 bps – the largest inversion in decades, as uncertainties remained around the growth outlook for 2023 in the face of an aggressive Federal Reserve.

Upward price movement from November continued into early December as new issue supply remained subdued, while demand from early December coupon and maturity reinvestment provided additional support. At the Federal Reserve meeting in mid-December, officials voted to boost the overnight borrowing rate by 50 bps, a downshift after four straight 75 bps moves. This brought the fed funds rate to the highest level since 2007 and included a hawkish forecast from officials and a commitment to "ongoing increases" to moderate inflation from elevated levels. Supply remained muted, coming in at just $17 billion compared to the previous five-year average for the month of $41 billion. For December, municipal yields moved lower in the 3-14 year spots, while short and long-end yields saw rates move marginally higher. In what has historically been a rare occurrence for tax-exempts, the 1-10 year AAA slope inverted on December 14th and remained inverted for the remainder of the year. The 10-year muni/Treasury relative value ratio closed the year slightly tighter than historical averages, at 68% versus an average of 77% for the quarter.

Supply

2022 ended with new issue supply of $387 billion. This was a year-over-year decline of nearly $100 billion vs. calendar year 2021 and the lowest annual figure since 2018. The drop-off in issuance is attributable to a sharp decline in refunding issuance as interest rates moved higher. New money issuance came in at $308 billion, a drop of just 4% year over year while refunding supply was down $83.5 billion, or 52% year over year.

Fund flows

Per Lipper data, the fourth quarter saw net outflows of $21 billion, though the period did see the first weekly reported inflow in 13 weeks, during the week ending November 16th. Following this period, the quarter closed with outflows in five of six weeks, pressuring yields a bit to close the quarter. For the year, municipal mutual funds experienced net outflows of $160 billion (per MMA data), the highest figure on record.

Positioning

After seeing municipals sell off for the third consecutive month in October, the market quickly turned around over the year's final two months. Stated AAA yields beyond one year moved lower by 49 to 79 bps over November and December, with the most significant move coming from the 5-12 year maturity range. The firming up in the market provided a more constructive environment for executing beneficial tax loss swaps – trades our team was active in executing throughout 2022, with activity picking up over the fourth quarter ahead of year-end. We opened the fourth quarter neutral on strategy duration positioning after allowing duration to drift shorter for much of the year in the face of rising rates. However, with the sharp move in rates that took place in 2022, we have begun to actively extend duration more in line with long-term targets with reinvestment from maturity roll-off and through the execution of swaps, ahead of the technically strong January period of low new issue supply and elevated coupon and maturity reinvestment demand.

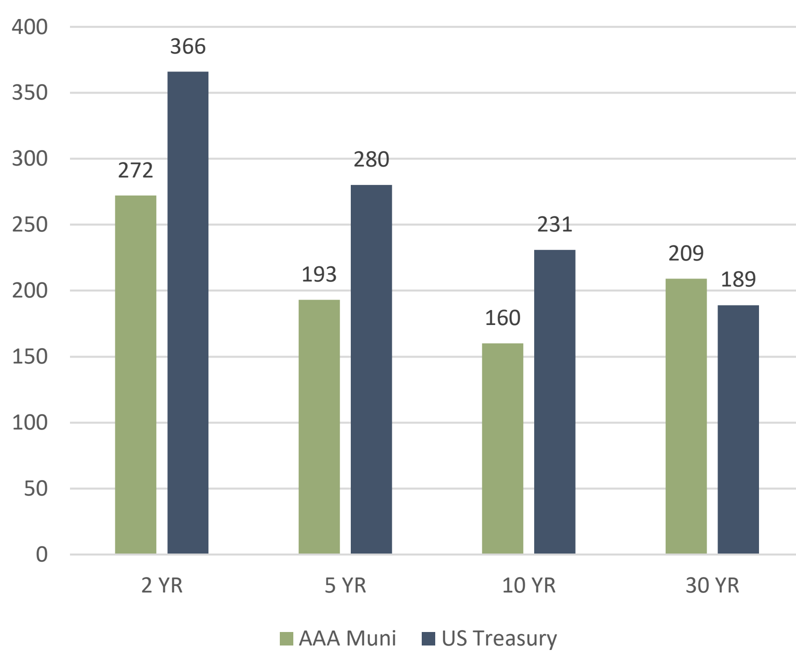
FIGURE 4

Muni / Treasury Ratios

Source: Municipal Market Data, US Treasury

FIGURE 5

2022 YTD Yield Change (basis points)



Source: Municipal Market Data, US Treasury

High Quality Intermediate

In response to market volatility over 2022, we have allowed duration to drift to the lower end of our range for the strategy. Much of the tax-loss swap activity executed throughout the year was on a duration-neutral basis – selling and buying bonds with similar maturity and call structures. As we head into 2023, we will look to make additional trades of selling bonds owned on the short end of the curve purchased in a lower rate environment and that have below current market book yields. With the proceeds, reinvestment will focus on bonds in the short to intermediate range. These trades serve to increase book yield and the level of tax-exempt income while also nudging average duration more in line with long-term targets.

This strategy's focus remains on high-quality bonds rated AA and up. However, with municipal credit fundamentals remaining sound, we will look to selectively add A-rated positions as we find opportunities to enhance portfolio yield.

Enhanced Intermediate

We came into 2022 targeting a higher quality tilt within Enhanced Intermediate, as credit spreads had reached record-tight levels. Additionally, we allowed duration to drift to the short end of our target while continuing to focus on premium coupon bonds to defend against extension risk. With the move higher in yields that has taken place, we are now looking to take advantage of opportunities to extend duration in line with our long-term target. Over the fourth quarter, we looked to add bonds whose prices have fallen to discounts, particularly 4-5% coupon structures, as available. Finally, with the municipal credit picture continuing to look strong, we will look to uncover pockets of value and add A and BBB-rated bonds with stable underlying metrics that we believe are well-positioned to weather any potential economic slowdown.

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